Using Negotiation, Mediation, and Arbitration to Resolve IRS-Taxpayer Disputes

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I. INTRODUCTION

Disputes between the Internal Revenue Service (IRS or Service) and taxpayers arise when a taxpayer fails to agree with an IRS finding,[1] refuses to file a tax return, or refuses to comply with an IRS request for information.[2] The stated mission of the IRS is to "[p]rovide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all."[3] This emphasis on service is seen not only in taxpayer understanding of the law, but also in the Service's dispute resolution process. The IRS aims at resolving taxpayer disputes at the earliest possible point in the resolution process.[4] In pursuit of this goal, the IRS has an Appeals Office (Appeals), which has a longstanding record of settling taxpayer disputes outside of a courtroom.[5] In recent years, the IRS has developed other, more formal and

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[1] INTERNAL REVENUE SERVICE, DEPARTMENT OF THE TREASURY, PUBLICATION 5, YOUR APPEAL RIGHTS AND HOW TO PREPARE A PROTEST IF YOU DON'T AGREE (1999) [hereinafter PUBLICATION 5], *available at* http://www.irs.gov/pub/irs-pdf/p5.pdf (last visited Sept. 23, 2003).

[2] Tonya M. Scherer, *Alternative Dispute Resolution in the Federal Tax Arena: The Internal Revenue Service Opens Its Doors to Mediation*, 1997 J. DISP. RESOL. 215, 216.

[3] INTERNAL REVENUE SERVICE, DEPARTMENT OF THE TREASURY, PUBLICATION 1, YOUR RIGHTS AS A TAXPAYER (2000) [hereinafter PUBLICATION 1], *available at* http://www.irs.gov/pub/irs-pdf/p1.pdf (last visited Sept. 23, 2003).

[4] *See* INTERNAL REVENUE SERVICE, DEPARTMENT OF THE TREASURY, PUBLICATION 2183, IRS CUSTOMER SERVICE STANDARDS ANNUAL REPORT FOR 1997 (1998) (noting that "Our goal is to satisfactorily resolve all your issues the first time you contact us."); *see also* John M. Beehler, *IRS Alternative Dispute Resolution Initiatives*, THE TAX ADVISOR, Feb. 2000, at 116; Internal Revenue Manual § 8.1.3.2, *available at* http://www.irs.gov/irm/index.html (last visited Sept. 23, 2003).

[5] The Appeals Office handles over 55,000 cases each year and settles taxpayer disputes before trial in 85% of those cases. *See* Appeals At-a-Glance, *at* http://www.irs.gov/irs/article/0,,id=96750,00.html (last visited Sept. 23, 2003); *see also Resolution of Federal Income Tax Controversies: New Tools and a New Attitude for a New Economy*, TAXES, Mar. 2001, at 267, 275 [hereinafter *Resolution of Federal Income Tax Controversies*] (reporting that Appeals handles approximately 58,000 cases, 90% of which are resolved through its settlement procedures).

narrowly focused, alternative dispute resolution (ADR) programs designed to add to the efficient resolution of disputes.[6] These programs include forms of negotiation, mediation, and arbitration and are aimed at both dispute prevention and resolution.[7] Additionally, mediation and arbitration are available even after a case reaches the United States Tax Court.[8] This Note will focus specifically on the presence of negotiation, mediation, and arbitration in the tax dispute resolution process, with particular attention to the use of those ADR mechanisms in Appeals.[9]

Despite the fact that the use of ADR for resolving tax disputes has shown great promise, both in Appeals and in more narrowly focused programs, room for growth and improvement remains. The focus in Appeals on taxpayer-Appeals officer negotiations deserves a critical look, particularly in

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[6] Scherer, *supra* note 2, at 217.

The use of ADR provides economic benefits for the IRS, taxpayers, and the court system. Less formal procedures may make it possible for taxpayers to avoid the cost of legal representation, and the IRS conserves resources with the expeditious resolution of cases outside of a courtroom. *See* Amy S. Wei, *Can Mediation Be the Answer to Taxpayers' Woes?: An Examination of the Internal Revenue Service's Mediation Program*, 15 OHIO ST. J. ON DISP. RESOL. 549, 551 (2000). Moreover, resolution of fact-laden cases prior to litigation lessens pressure on the courts. *See* David P. Korteling, Comment, *Let Me Tell You How It Will Be; Here's One For You, Nineteen For Me: Modifying the Internal Revenue Service's Approach to Resolving Tax Disputes*, 7 ADMIN L.J. AM. U. 659, 663, 682–83 (1994). Finally, even when mediation is unsuccessful, the process can provide benefits. *See* Charles L. Measter & Peter Skoufalos, *The Increasing Role of Mediation in Resolving Shipping Disputes*, 26 TUL. MAR. L.J. 515, 528 (2002) (noting that "[e]ven if the cases are not settled by mediation, the process has helped narrow the issues to be heard at trial").

[7] *See* Beehler, *supra* note 4, at 116 (noting that programs include issue resolution before a return is filed and dispute resolution at the Appeals level and after litigation has begun).

[8] *See* U.S. TAX COURT RULES OF PRACTICE AND PROCEDURE, Rule 124 (2000) [hereinafter T.C.R.]. For a description of how a case finds its way to United States Tax Court, see *infra* Part II. Taxpayers and the IRS can save time and money when litigation is avoided, and Tax Courts can benefit from a decrease in the number of cases burdening their dockets. Formal procedural rules have already established arbitration as a viable alternative to litigation in Tax Court, and arbitration should continue to be encouraged there. The absence of formal procedural rules for mediation, however, limits the use of mediation in Tax Court. This is particularly unfortunate given the fact that tax disputes are particularly well suited for resolution through mediation. Accordingly, formal mediation procedures should be developed for Tax Courts. *See infra* Part II.B.2.

[9] The primary focus of this Note is the use of ADR after a tax dispute has arisen. For a survey of some of the dispute prevention mechanisms used by the IRS, see generally Thomas Carter Louthan & Steven C. Wrappe, *Building a Better Resolution: Adapting IRS Procedures to Fit the Dispute*, 13 TAX NOTES INT'L 1473, 1473 (1996); Beehler, *supra* note 4.

regard to its effect on taxpayers with either very small or very large claims. Specifically, the overall fairness of the system for taxpayers with small claims is questionable, considering the fact that these taxpayers will invest relatively little time and money in a vigorous defense.[10] Few are likely to invest in legal representation, and many will value early settlement over a prolonged resolution that would eventually subsume the total value of the claim. Accordingly, the settlements that are reached may not be totally fair for small taxpayers. Moreover, negotiation is not particularly conducive to the settlement of large tax disputes. In cases where tens or hundreds of thousands of dollars separate the positions of the IRS and the taxpayer, ardent representation is warranted because even after prolonged litigation, the taxpayer may come out ahead.[11] A shift in the structure of Appeals from a focus on negotiation to mediation may alleviate these specific problems regarding large and small taxpayers.[12] In mediation, the involvement of an independent, neutral third party will address the inequities that typically arise with small claims.[13] Furthermore, an independent neutral is likely to force taxpayers and Appeals officers to fairly assess the strength and fairness of their positions, which would ultimately result in the settlement of a greater number of large claims.[14]

This Note will examine the use of negotiation and mediation throughout the tax dispute resolution process, focusing specifically on the Appeals process, and suggest how these mechanisms can be more fully utilized by the IRS. This Note will also briefly discuss the extent to which arbitration is utilized in tax dispute resolution. Part II will examine the broad structure of tax dispute resolution. This will include a discussion of the history, procedure, and success of the Appeals Office and analysis of the more narrowly focused ADR programs that have emerged in recent years. Part III will offer a critique of how ADR is utilized in the tax dispute resolution process. This will include examination of overall mediator impartiality and

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[10] *See infra* Part III.A.

[11] *Id.*

[12] *See infra* Part IV.

[13] *See* STEPHEN J. WARE, ALTERNATIVE DISPUTE RESOLUTION § 4.13 (2001) (describing how evaluation of the parties' positions may counter power imbalances and help lead to fairer settlements). Mediator impartiality is also an important factor that reduces the impact of a power imbalance between the parties. That is, an impartial mediator ensures that a settlement is fair to both parties. *See id.* § 4.15; *see also infra* Part IV.

[14] *See* WARE, *supra* note 13, § 4.13 (explaining the significance of a neutral mediator's evaluation of each party's claim in the settlement process). Also, a mediator may act to overcome "barriers to settlement" so that the parties will both move toward a mutually acceptable "settlement zone." *Id.* § 4.11; *see also infra* Part IV.

the adequacy of the application of ADR in Appeals. Part IV will suggest a broader employment of mediation by the IRS.

II. TAX DISPUTE RESOLUTION STRUCTURE

Prior to examining the methods of resolving disputes, a cursory view of the conflict process is helpful. Conflicts generally begin through the audit process.[15] If an audit is not followed by an agreement between the taxpayer and the IRS agent concerning the amount of tax owed,[16] the taxpayer may file a protest letter with Appeals[17] or pursue his claim legally (*i.e.*, in court).[18] If the taxpayer chooses not to submit his case to Appeals, or if

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[15] A taxpayer may be audited because his return has been red-flagged by the IRS because of a possible problem or inaccuracy, or the audit may be a result of random selection. *See* PUBLICATION 1, *supra* note 3; *see also* Korteling, *supra* note 6, at 662–63. *See generally* INTERNAL REVENUE SERVICE, DEPARTMENT OF THE TREASURY, PUBLICATION 3498, THE EXAMINATION PROCESS (2003) [hereinafter PUBLICATION 3498], *available at* http://www.irs.gov/pub/irs-pdf/p3498.pdf (last visited Sept. 23, 2003) (outlining the audit examination process). Relatively few tax returns are audited each year. The General Accounting Office (GAO) reported that in 2000, 0.49% of all tax returns filed by individuals were audited. UNITED STATES GENERAL ACCOUNTING OFFICE, IRS AUDIT RATES (2001), *available at* http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=gao&docid=f:d01484.pdf (last visited Sept. 23, 2003). This audit rate is down 70% from 1996, when 1.67% of individual tax returns were audited. *Id.*

[16] The taxpayer's initial communication with the IRS regarding a disputed finding consists of a meeting with the supervisor of the person who made the finding. PUBLICATION 5, *supra* note 1. This meeting may result in an agreement and can take place either in person or over the telephone. *Id.* Realistically, the taxpayer has little opportunity to engage in substantive negotiations with the IRS agent while the case is still in the audit process. *See* Keith Gercken et al., *Dancing to the Right Tune: A Comparative Discussion of Negotiations with Revenue Authorities*, 16 TAX NOTES INT'L 1367, 1367 (1998). This is because the IRS agent is not permitted to consider the hazards of litigation and the strength of the Service's position at this point. *Id.* Because the IRS agent must rigidly adhere to the IRS finding, very little negotiation actually takes place at this stage in the administrative process. *Id. See generally* PUBLICATION 3498, *supra* note 15 (outlining procedure at the audit stage of the dispute).

[17] For a summary of the Appeals process, see *infra* Part II.A.

[18] The IRS encourages taxpayers to pursue resolution through its Appeals Office, but taxpayers have the right to pursue their claims directly in court. *See* PUBLICATION 5, *supra* note 1. If the dispute involves a question of whether a particular amount of tax is owed, the taxpayer would pursue his claim in United States Tax Court. *Id.* If a taxpayer seeks a refund of money already paid, he would pursue his claim in either United States District Court or in Federal Claims Court. *Id.*; *see also* Korteling, *supra* note 6, at 668–69.

resolution is unsuccessful after the Appeals process has run its course, he may sue the IRS.[19]

A. *The Appeals Office: Negotiation*

With the establishment of the Appeals Office in 1927, [20] the IRS first embraced the value of resolving taxpayer disputes without litigation.[21] The Appeals Office operates independently from the local IRS office with which the taxpayer has interacted; however, a case that goes to Appeals remains under the jurisdiction of the IRS.[22] An appeal to the Appeals Office represents an administrative option to contest a claim of the IRS, and it is designed to be an impartial forum[23] in which a taxpayer can try to settle the dispute.[24]

A taxpayer can initiate the Appeals process by filing a protest letter.[25] An Appeals officer then considers the merits of the case and the time and cost of

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[19] *See* Korteling, *supra* note 6, at 668–69. By directing a claim to Appeals, a taxpayer does not lose his right to pursue the claim in court. *Id.*

[20] *See* Louthan & Wrappe, *supra* note 9, at 1473.

[21] *See* Korteling, *supra* note 6, at 668–69 (noting that at the administrative appeals stage "the IRS has substantial ADR efforts"). Further evidence of the Service's mission to resolve disputes prior to litigation is the "exhaustion rule," which limits an award of attorney's fees to only those cases in which all available administrative remedies have been exhausted. *See* William E. Taggart, *Corporation Argues Payment for Consulting Services Is Deductible*, TAX NOTES TODAY (June 18, 2002), LEXIS 2002 TNT 117-37; 26 U.S.C. § 7430 (b)(1) (2000). The exhaustion rule is designed to "encourage taxpayers and the IRS to administratively resolve tax disputes and to discourage the resolution of such disputes through litigation." Taggart, *supra*.

[22] *See* INTERNAL REVENUE SERVICE, DEPARTMENT OF THE TREASURY, PUBLICATION 556, EXAMINATION OF RETURNS, APPEAL RIGHTS, AND CLAIMS FOR REFUND (1999) [hereinafter PUBLICATION 556], *available at* http://www.irs.gov/pub/irs-pdf/p556.pdf (last visited Sept. 23, 2003). Once a case is pursued in court, on the other hand, it is under the jurisdiction of that court. *Id.*

[23] The IRS emphasizes the fairness of the Appeals Division by describing it as an office "separate from—and independent of—the IRS Office taking the action [the taxpayer] disagree[s] with." PUBLICATION 5, *supra* note 1.

[24] If a case fails to come to resolution while under the jurisdiction of the Appeals Division, settlement is still possible, even after litigation has commenced. The Department of Justice Tax Division, which handles tax cases in Federal District Court, also has developed a policy regarding the settlement of tax disputes. *See* United States Department of Justice Tax Division, Alternative Dispute Resolution Case Selection Criteria, *available at* http://www.usdoj.gov/tax/readingroom/jcmanhtm/exh40.pdf (last visited Sept. 23, 2003).

[25] Louthan & Wrappe, *supra* note 9, at 1473. A taxpayer is required to submit an extensive protest letter in almost all cases. Among the items a protest letter must include

litigation to arrive at a settlement figure.[26] An Appeals conference is then scheduled so that the Appeals officer and the taxpayer can attempt to negotiate a mutually acceptable settlement.[27]

The Appeals process is designed to be neutral and has the purpose of effecting decisions regarding the settlement of taxpayer disputes.[28] After reviewing the facts and evidence, and upon considering the hazards of litigation, the Appeals officer determines a fair position for the IRS.[29] The IRS model is designed so that the Appeals officer enters the settlement negotiations with a "quasi-judicial"[30] attitude embodying an "open mind and [with] genuine interest in working out a mutually acceptable agreement."[31] The primary focus of the Appeals process is negotiation.[32] That is, the taxpayer and Appeals officer try to settle the dispute "through persuasion regarding the merits of their respective positions."[33] The taxpayer has the

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are a formal request for Appeals consideration, a statement of the facts surrounding the claim at issue, a summary of the legal arguments on which the taxpayer relies, and a statement attesting to the truth of the contents of the letter accompanied by the taxpayer's signature. *See* PUBLICATION 5, *supra* note 1. Claims under $25,000 are considered "small case requests" and do not require a full protest letter. *Id.* A "small case request" consists of a letter that requests Appeals consideration, indicates areas of disagreements, and explains the reasons for the disagreement. *Id.*

[26] Louthan & Wrappe, *supra* note 9, at 1474.

[27] PUBLICATION 5, *supra* note 1. The Appeals conference is designed to minimize tension and maximize convenience for the taxpayer. "Conferences with Appeals Office personnel are held in an informal manner by correspondence, by telephone or at a personal conference." *Id.*

[28] *See* Scherer, *supra* note 2, at 215. The Appeals officer is neutral in the sense that he does not act purely "as an advocate of the IRS position developed by IRS Examination." Louthan & Wrappe, *supra* note 9, at 1474.

[29] *See* Louthan & Wrappe, *supra* note 9, at 1474. "Hazards of litigation" refers to the cost-benefit analysis regarding the probability of success through litigation. *See* Korteling, *supra* note 6, at 667–68 n.44. Prior to the Appeals stage, an IRS auditor may not consider the hazards of litigation while trying to negotiate an agreement with the taxpayer. *See* Louthan & Wrappe, *supra* note 9, at 1474.

[30] Internal Revenue Manual § 8.6.1.2.3, *available at* http://www.irs.gov/irm/index.html (last visited Sept. 23, 2003).

[31] *Id.*

[32] For a general overview of negotiation practice and principles, see WARE, *supra* note 13, § 3.

[33] Alan H. Friedman, *Should the State Tax Community Use Alternative Dispute Resolution Processes? Or, Should We Just Keep on Throwing Stones?*, 22 STATE TAX NOTES 765, 766 (2001) (describing the appeals process in state tax agencies, which have appeals procedures analogous to the Appeals Office of the IRS).

right to have representation at an Appeals conference, but, according to the IRS, representation is not necessary.[34]

The use of negotiation by Appeals represents a system designed to cover a broad range of disputes[35] and has shown great success statistically. In fact, between eighty-five and ninety percent of the cases that reach Appeals result in settlement.[36] However, in 1996, Congress mandated that all government agencies begin to implement ADR into their administrative dispute resolution processes.[37] Additionally, the IRS Restructuring and Reform Act of 1998 has led the IRS to develop more formal ADR policies and procedures.[38] This congressional action, along with a desire for greater efficiency, has brought about the development of mediation and arbitration programs designed to supplement the existing Appeals process.[39]

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[34] *See* PUBLICATION 5, *supra* note 1.

[35] *Id.* (noting that taxpayers "may appeal most IRS decisions with [their] local Appeals Office.").

[36] *See supra* note 5.

[37] *See* Administrative Dispute Resolution Act, 5 U.S.C. §§ 571–84 (1998) [hereinafter ADRA]; *see also* Scherer, *supra* note 2, at 215 (noting how the ADRA "has enhanced the recent trend toward the implementation of ADR procedures"); *see also* Wei, *supra* note 6, at 552 (noting that the purpose of the ADRA is "to encourage federal agencies to 'reap the benefits of ADR processes'") (citing Robin J. Evans, Note, *The Administrative Dispute Resolution Act of 1996: Improving Federal Agency Use of Alternative Dispute Resolution Processes*, 50 ADMIN. L. REV. 217, 233 (1998)).

The ADRA has led many federal agencies to establish dispute resolution programs. By 2000, more than twenty-nine federal agencies had at least begun to develop such programs. *See* Jim Rossi, *Bargaining in the Shadow of Administrative Procedure: The Public Interest in Rulemaking Settlement*, 51 DUKE L.J. 1015, 1019 n.9 (2001); *see also* MARSHALL J. BREGER, *The Administrative Dispute Resolution Act of 1996 and the Private Practitioner*, *in* FEDERAL ADMINISTRATIVE DISPUTE RESOLUTION DESKBOOK 1, 10–11 (2001). For a discussion of how other federal agencies have implemented ADR procedures, see Daniel Marcus & Jeffrey M. Senger, *ADR and the Federal Government: Not Such Strange Bedfellows After All*, 66 MO. L. REV. 709, 719–22 (2001) (discussing the use of mediation by the United States Postal Service, the Department of Health and Human Services, and the Environmental Protection Agency); Michael Z. Green, *Proposing a New Paradigm for EEOC Enforcement After 35 Years: Outsourcing Charge Processing By Mandatory Mediation*, 105 DICK. L. REV. 305, 332 (2001) (discussing how the mediation program used by the EEOC has helped reduce its backlog of cases); Charles C. Caldart & Nicholas A. Ashford, *Negotiation As a Means of Developing and Implementing Environmental and Occupational Health and Safety Policy*, 23 HARV. ENVTL. L. REV. 141, 143 (1999) (discussing the development of negotiated rulemaking with OSHA and EPA).

[38] Pub. L. No. 105-206, 112 Stat. 685.

[39] *See* Scherer, *supra* note 2, at 217 (noting that the new programs started by the IRS "target specific types of disputes so as to insure that the new procedures do not undermine the Appeals process").

B. *Formal ADR Initiatives: Mediation and Arbitration*[40]

As a result of congressional mandate[41] and as part of its efforts to make substantial gains in improving its image and service,[42] the IRS has developed formal dispute resolution mechanisms for tax cases.[43] With the historically high settlement rate experienced by Appeals, the IRS initially designed its more formal ADR programs to supplement, rather than replace, the existing system.[44] That is, new initiatives tend to have a more narrow focus, as compared to Appeals.[45]

1. *Mediation*

Mediation is available throughout the dispute resolution process: first while the case is under the jurisdiction of the IRS, and second when the case is in the Tax Court's jurisdiction.[46] The IRS has made significant efforts to expand the availability of mediation as another tool to effect agreement.[47]

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[40] The IRS offers many dispute resolution programs other than Appeals negotiation, mediation, and arbitration that are beyond the scope of this Note. For a good summary of other IRS ADR programs available before and after the taxpayer files his return, see generally Beehler, *supra* note 4, at 116.

[41] *See* Administrative Dispute Resolution Act, 5 U.S.C. §§ 571–584 (1998) (requiring federal agencies to develop ADR programs); IRS Restructuring and Reform Act of 1998, Pub. L. No. 105-206, 112 Stat. 685 (enacting § 7123 of the Internal Revenue Code, which makes arbitration and non-binding mediation available to taxpayers); *see also* Wei, *supra* note 6, at 552–53; Scherer, *supra* note 2, at 215.

[42] *See* Wei, *supra* note 6, at 554 (explaining how the IRS is working to "becom[e] a customer-oriented agency"); *see also* Larry R. Langdon, *Resolving Actual and Potential Disputes with the IRS in the New Economy*, TAXES, Mar. 2001, at 261, 262 [hereinafter *Resolving Actual and Potential Disputes*] (noting that emphasis on issue resolution rather than litigation has discouraged the raising of "issues that don't have legal substance").

[43] The Service's advance pricing agreement (APA) program, begun in 1991, marked an early experimentation with ADR. *See* Beehler, *supra* note 4, at 116. That program focused on resolving international intercompany price issues prior to the actual filing of a return. *Id.* By 1995, the IRS had established a one-year test period for the limited use of mediation. *See* Scherer, *supra* note 2, at 219. Additionally, in 1990, the Tax Court adopted Rule 124, which made available voluntary arbitration. *Id.* at 218 n.27.

[44] *See* Scherer, *supra* note 2, at 215 (noting that non-Appeals resolution programs are directed at specific types of tax disputes).

[45] *See* Louthan & Wrappe, *supra* note 9, at 1474; Wei, *supra* note 6, at 552. For example, mediation is typically available only after the traditional Appeals process has failed to render a settlement. *Id.*

[46] *See* 26 U.S.C. § 7123 (2000); T.C.R. 124 (2000); *see also infra* note 48.

[47] *See* Rev. Proc. 2002-44, 2002-26 I.R.B. 10 § 2 (establishing the procedure for mediation within Appeals); Ken C. Jones, *An Expanded Appeals Mediation Program*

Mediation has seen less success in Tax Court, however, due in large part to the fact that formal procedures have yet to be developed.[48]

Mediation can be thought of as "negotiation plus."[49] That is, it takes the principles of negotiation (*i.e.*, evaluation and persuasion)[50] and adds a third party to facilitate an agreement.[51] The mediator is essentially a third party through whom the parties can engage in negotiation.[52] The success of mediation, then, depends on the presence of open communication[53] and

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with a Restriction, TAX NOTES TODAY (Sept. 25, 2002), LEXIS 2002 TNT 186-30 (describing the broad availability of mediation); *see also* Wei, *supra* note 6, at 549 (citing time and money savings as an important factor in the development of mediation by the IRS).

[48] *See* Erin M. Collins, *Mediation Should Be Available to All Taxpayers*, TAX NOTES TODAY (Aug. 8, 2002), LEXIS 2002 TNT 153-77. Cases that have not successfully reached settlement and which enter litigation may still be settled by mediation in Tax Court or another federal court. *See id.*; *see also* Korteling, *supra* note 6, at 668–69 (discussing the various federal court forum alternatives available for taxpayers). Mediation is not mandatory in Tax Court, but Tax Court judges have allowed parties to pursue mediation under the authority of Rule 124 or under their general discretion. When mediation has been pursued in Tax Court, the parties have worked together to come up with ad hoc guidelines. *See* Collins, *supra*. Tax Court Rule 124 focuses on the availability of and procedure for voluntary binding arbitration, and although the rule does not provide similar guidelines for mediation, mediation is still available in Tax Court. Section (b)(5) of Rule 124 explicitly states that "[n]othing contained in this Rule shall be construed to exclude use by the parties of other forms of voluntary disposition of cases, including mediation." T.C.R. 124. Mediation is also available if the case is in United States District Court. Specifically, the court can order the parties to engage in non-binding mediation. For an example of rules and procedure associated with mediation in United States District Court, see Lee v. Commissioner, No. C-00-285, 2000 U.S. Dist. LEXIS 16324 (S.D. Tex. Sept. 14, 2000). Despite the absence of formal guidelines, mediation while under the jurisdiction of a federal court typically looks similar to mediation in Appeals. That is, mediation is generally entered into voluntarily by the parties, is non-binding, and involves a neutral third party mediator. In Tax Court mediation, either the Tax Court judge or a Special Trial Judge acts as mediator and in *Lee v. Commissioner* the mediator could not have "any financial or personal interest in the result of the mediation." *Lee*, 2000 U.S. Dist. LEXIS 16324, at *3.

[49] WARE, *supra* note 13, § 4.2.

[50] *See supra* text accompanying note 29.

[51] *See* WARE, *supra* note 13, § 4.2.

[52] *See id.* Ultimately, mediation "places the parties in control of resolving their case, and provides the opportunity to argue the merits of the case before a fresh face, with a qualified mediator adding a whole new dimension to the negotiation process." Sharon Katz-Pearlman & Jonathan S. Adelson, *IRS Restructuring and Transfer Pricing Enforcement*, 20 TAX NOTES INT'L 2617, 2626 (2000).

[53] *See* Alexei P. Mostovoi, *Tax Mediation: Is It Just a Test?*, 13 TAX NOTES INT'L. 1871, 1875 (1996). When the parties are "forthcoming . . . in releasing information . . . the mediator and the parties are likely to be more creative in identifying solutions

trust[54] among the participants. More open communication can be accomplished when the confidentiality of the mediation session is guaranteed.[55] For example, when parties are confident that the information they disclose cannot be used against them in a subsequent legal action, they will be more likely to engage in full disclosure.[56] Likewise, a greater degree of trust results when the parties are confident that the mediator is impartial. The importance of mediator impartiality centers on the fact that one of the mediator's roles is to evaluate the merits of the claims of each party and to engage the parties in discussion and compromise.[57] Ultimately, parties will be less willing to fully disclose information and wholly accept the mediator's evaluation of their claim if they have the impression that the mediator is partial to the other side. Therefore, with the preservation of confidentiality and impartiality, information can be freely shared among the mediation participants, which, in turn, will allow the mediator to gain an accurate understanding of the claims.[58]

Several factors characterize the mediation of tax disputes. Primarily, mediation is typified by "informality" and "flexibility" and is "voluntary . . . and nonbinding [in] nature."[59] The ability to mold the process to the needs of the parties[60] and the use of informal rules of evidence[61] make

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[because] they have sufficient understanding of the interests and objectives of each participant in the process." *Id.*

[54] *See id.* at 1878 (noting that a mediator's conflict of interest may affect the trust among the parties and "taint the substantive outcome" of mediation); *see also* WARE, *supra* note 13, § 4.2 (noting the importance of the fact that a mediator is the "agent" of neither party).

[55] *See* Mostovoi, *supra* note 53, at 1875–76.

[56] *See id.* (noting that "the availability and extent of legal protection from subsequent disclosure" is directly related to the "willingness of the parties to provide and exchange information").

[57] *See* WARE, *supra* note 13, § 4.13. The evaluation of the merits of each party's claim is important in recognizing a "settlement zone" in which the parties may come to an agreement. *Id.* Evaluation is vital because it may be the necessary step for a party to realize that it has over-estimated the strength of its claim. *Id.*

[58] *See* Mostovoi, *supra* note 53, at 1875. Full understanding of the claims will help the mediator act as a facilitator by allowing her to intelligently define the issues. *See* Rev. Proc. 2002-44, 2002-26 I.R.B. 10 § 2 (2002).

[59] Wei, *supra* note 6, at 555.

[60] *Id.*

[61] David F. Rock, *A First-Hand Look at Mediation with the Service: How to Make the Most of It*, 93 J. TAX'N 69, 72 (2000).

mediation particularly attractive.[62] Furthermore, because it is nonbinding, the taxpayer has little to lose—in the event that an acceptable settlement is not reached, litigation can still be pursued.[63] Second, mediation forces both parties to seriously examine their claims as they prepare for the mediation session[64] and ensures that a neutral third party will examine the merits of each side's claims anew, providing an untainted perspective in the dispute.[65] Ultimately, the availability of mediation gives the taxpayer and the IRS one more opportunity to resolve the dispute in a relatively fast and cost-effective manner.[66]

The mentality within the IRS is that the use of mediation can supplement the success of Appeals.[67] In fact, non-binding mediation is generally available only at the conclusion of the traditional Appeals process.[68] The

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[62] An additional benefit of mediation is the fact that it is not limited to "predefined legal remedies," so that the parties can work together, and even compromise, to reach an acceptable end. *See* Wei, *supra* note 6, at 555–56.

[63] Collins, *supra* note 48; *see also* Rev. Proc. 2002-44, 2002-26 I.R.B. 10 § 2.

[64] Jones, *supra* note 47. The parties are actually involved in face-to-face mediation for one or two days, but the entire mediation process usually takes about 120 days. *See* Collins, *supra* note 48; *see also* Beehler, *supra* note 4, at 116.

[65] *Resolution of Federal Income Tax Controversies*, *supra* note 5, at 276.

[66] Collins, *supra* note 48.

The cost-effectiveness of mediation is emphasized with an examination of a case that reached settlement through mediation in 1999. *See generally* Rock, *supra* note 61, at 69. The case involved a factual dispute over the value of a piece of real estate, and "[a]fter lengthy and arduous negotiations, the parties were at an impasse." *Id.* There was significant disparity between the respective proposals made by the Appeals officer and the taxpayer, and normally, litigation would have been the next inevitable step. *Id.* However, when mediation was pursued at the suggestion of the taxpayer's attorney, settlement was ultimately reached in an eight-hour session. *Id.* The taxpayer's attorney credited the success of mediation to the informality of the process and the fact that the presence of a neutral third party forced the parties to reexamine the strength of their respective proposals. *Id.* at 72.

[67] For example, Larry Langdon, director of the Large and Mid-Size Business Division stated, "The new tools that we have today, combined with the tools we have used in the past, provide the means to solve problems." *Resolution of Federal Income Tax Controversies*, *supra* note 5, at 268.

[68] *See* 26 U.S.C. § 7123 (b)(1)(A) (2002); *see also* Rev. Proc. 2002-44, 2002-26 I.R.B. 11 § 4.01 (explaining that mediation "may be used only after Appeals settlement discussions are unsuccessful"); Wei, *supra* note 6, at 557 (noting that the use of mediation is limited to situations where Appeals negotiations have failed).

Mediation is available before the Appeals process even begins, but at that stage a major limitation is present. *See* INTERNAL REVENUE SERVICE, DEPARTMENT OF THE TREASURY, PUBLICATION 3605, FAST TRACK MEDIATION: A PROCESS FOR PROMPT RESOLUTION OF TAX ISSUES (2001) [hereinafter PUBLICATION 3605], *available at* http://www.irs.gov/pub/irs-pdf/p3605.pdf (last visited Sept. 25, 2003). That is, fast track

Service's first experiment with mediation came in 1995, with limited scope and availability.[69] Three years later Congress required the development of procedures for the availability of mediation in the Appeals process.[70] In 2002, the mediation program became a permanent part of the Appeals process and even greater expansions in availability were made, with the removal of many of the eligibility requirements.[71] In fact, effective July 1, 2002, the IRS completely abolished the amount in controversy requirement, "mak[ing] mediation available to a much wider taxpayer audience than previously was the case."[72] Additionally, mediation is no longer limited to the resolution of factual issues.[73] This change makes mediation "available for

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mediation is limited because it takes place prior to the case entering the jurisdiction of the Appeals Office. The case's jurisdictional status is of crucial significance because when a case is in the examination phase, the IRS agent is not permitted to consider the hazards of litigation in his settlement figure. *See* Gercken et al., *supra* note 16, at 1367; *see also* PUBLICATION 3498, *supra* note 16. This, in turn, will affect the ultimate ability to have any substantive and productive negotiations. *See* Part II.A, *supra* note 17. The IRS initiated pilot fast track mediation programs for large and mid-size business and small business and self-employed taxpayers that were designed to further expedite the availability of mediation. *See* Sheryl Stratton, *LMSB: At Work for Tax Executives*, TAX NOTES TODAY (Mar. 20, 2002), LEXIS 2002 TNT 54-3; Internal Revenue Service, *IRS Offers Faster Resolution of Tax Disputes*, TAX NOTES TODAY (June 27, 2002), LEXIS 2002 TNT 124-19 [hereinafter *Faster Resolution*]. These programs allowed qualifying taxpayers to by-pass the traditional settlement option offered by Appeals and proceed directly to mediation. *See* Rock, *supra* note 61, at 69. The fast track programs are designed to produce resolution within 120 days. *See* Stratton, *supra*. They also focus on "resolving controversy at the earliest resolution point within the IRS." *Faster Resolution*, *supra*. In fast track mediation, an Appeals officer who is trained in mediation acts as the mediator. *See* PUBLICATION 3605, *supra*. For a critique of fast track mediation see *infra* Part IV.

[69] *See* Rock, *supra* note 61, at 69. This first program was relatively limited, with few cases meeting the narrow eligibility requirements. *Id.* At its initiation, mediation was available only for Coordinated Examination Program (CEP) cases, and was limited to cases involving over $10 million. *Id.* at 70 n.1; Jones, *supra* note 47. However, by 1998 mediation became available (also on a trial basis) to help resolve factual issues in cases involving $1 million or more. *See* Rock, *supra* note 61, at 69.

[70] Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, 112 Stat. 685 (codified as 26 U.S.C. § 7123) (requiring the IRS to make non-binding mediation available for cases that are unresolved after the negotiation in Appeals); *see also* Gerald A. Kafka, *Restructuring and Reforming the IRS and the Code—Congress Takes a Quantum Leap*, 89 J. TAX'N 133, 139 (1998) (mentioning increased availability of ADR as one of the many taxpayer service improvements required by Congress).

[71] *See* Jones, *supra* note 47; *see also* Rev. Proc. 2002-44, 2002-26 I.R.B. 10.

[72] Jones, *supra* note 47; *see also* Rev. Proc. 2002-44, 2002-26 I.R.B. 10.

[73] Rev. Proc. 2002-44, 2002-26 I.R.B. 10.

any qualifying issues . . . that are already in the Appeals administrative process."[74] The progressive increase in the popularity of mediation is the result of success of the various trial programs since 1995, and it demonstrates an effort by the Service to ensure that even more cases avoid litigation.[75] One significant limitation remains for the availability of mediation in Appeals.[76] Namely, Appeals mediation is available only after taxpayer-Appeals officer negotiations have failed.[77]

2. *Arbitration*

Arbitration is also available for the resolution of tax disputes. Theoretically, arbitration is available both while a case is under the jurisdiction of the IRS and after it has gone to Tax Court.[78] If both negotiation and mediation have failed in Appeals, the taxpayer may request arbitration for the issue.[79] However, the use of arbitration has been largely limited to cases that are in Tax Court. This is due, in large part, to the fact that the IRS has only recently extended the availability of arbitration in Appeals.[80]

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[74] *Id.*

[75] *See* Jones, *supra* note 47. Evidence of the Service's attitude about the avoidance of litigation is seen in a statement by the director of its Large and Mid-Size Business Division: "I don't think mediation is for everyone, but it really looks like a win/win situation for the taxpayer and Appeals in many cases." *Resolution of Federal Income Tax Controversies*, *supra* note 5, at 276.

[76] It is important to distinguish "mediation in Appeals" from Fast Track Mediation, which takes place prior to the case coming under the jurisdiction of Appeals. *See* PUBLICATION 3605, *supra* note 68.

[77] Rev. Proc. 2002-44, 2002-26 I.R.B. § 4.01 (stating mediation "may be used only after Appeals settlement discussions are unsuccessful").

[78] *See* T.C.R 124 (2000); 26 U.S.C. § 7123 (b)(2) (2002).

[79] *See* Rev. Proc. 2002-44, 2002-26 I.R.B. § 5.16; *see also* Announcement 2002-60, 2002-26 I.R.B. 28.

[80] *See* Internal Revenue Service, *IRS Announces Extension of Test of Arbitration*, TAX NOTES TODAY (June 10, 2002), LEXIS 2002 TNT 111-17 [hereinafter *Extension of Test of Arbitration*]; *see also* Scherer, *supra* note 2, at 218 n.27.

Arbitration is available in Tax Court when the taxpayer and IRS agree, through a joint motion, to submit the case to arbitration. *See* Korteling, *supra* note 6, at 669. The parties can pursue arbitration at any time prior to the beginning of trial. *Id.* Arbitration takes place under the supervision of the Tax Court. *Id.* Along with their motions, the parties are each required to stipulate the issues to be resolved and agree to be bound by the decision of the arbitrator. T.C.R. 124 (b)(2) (2000). The arbitrator is then appointed by the Tax Court. *See* 35 Am. Jur. 2D *Federal Tax Enforcement* § 846 (2001). Although the arbitrator is technically appointed by the Tax Court, the parties do have some input into arbitrator selection. The Tax Court judge appoints the arbitrator based on whom the

Arbitration is a more formal dispute resolution process that involves a third party arbitrator with settlement authority.[81] That is, once the parties have submitted their case to arbitration, the decision of the arbitrator is binding. Arbitration provides two primary benefits over litigation—relaxed rules of evidence and a relaxed adversarial setting.[82] These factors are particularly advantageous for taxpayers who do not have legal representation because less legal expertise is required.

Congress, as part of the IRS Restructuring and Reform Act of 1998, mandated that the Service develop a pilot program for arbitration in the Appeals Office.[83] In 2000, Appeals first established its pilot arbitration program.[84] As of July 2002, binding arbitration is generally available for all cases in Appeals for which negotiations have failed.[85] The latest extension of the availability of arbitration has not made it a permanent fixture in Appeals, however.[86] Ultimately, the characteristics of arbitration limit its availability and attractiveness[87] and make mediation a more likely preference for many taxpayers.[88]

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parties have jointly agreed to or based on selection procedure agreed to by the parties. *See* T.C.R. 124 (b)(2)(C) (2000). Tax Court Rule 124 details the procedure that leads up to arbitration. Significantly, arbitration is limited to the resolution of factual issues only; therefore, unresolved legal issues may not be submitted. Also, arbitration differs significantly from mediation in that the decision of the arbitration panel is binding. *Id.*; *see also* Korteling, *supra* note 6, at 670. "To avoid the [due process concerns] that arise . . . when an arbitrator performs a judicial function, the Tax Court must retain authority to review the final decision. Thus, the Court must 'supervise' the arbitration, and the parties must agree to be bound by the arbitrators' findings." *Id.*

[81] *See* JACQUELINE M. NOLAN-HALEY, ALTERNATIVE DISPUTE RESOLUTION 138 (2001).

[82] *See* Korteling, *supra* note 6, at 681.

[83] 26 U.S.C. § 7123 (b)(2) (2002) (calling for a program that would allow the taxpayer and Appeals officer to jointly request arbitration for unresolved issues).

[84] I.R.S. Announcement 2000-4, 2000-1 C.B. 317.

[85] *See Extension of Test of Arbitration*, *supra* note 80. The Appeals Office has a preference for traditional negotiation. This is evidenced by the fact that neither mediation nor arbitration are available in Appeals until after taxpayer-Appeals officer negotiations have failed. *See* Rev. Proc. 2002-44, 2002-26 I.R.B. § 4.01 (noting that mediation is available only when traditional Appeals has failed); *Extension of Test of Arbitration*, *supra* note 80 (noting that arbitration is available only when traditional Appeals has failed).

[86] *See Extension of Test of Arbitration*, *supra* note 80 (the pilot program ran from July 1, 2002 to June 30, 2003).

[87] Mediation is a more attractive option for taxpayers because it is nonbinding and much more flexible. *See* Wei, *supra* note 6, at 555. In mediation, the parties are free to withdraw at any time. *Id.* A taxpayer may be less likely to pursue arbitration if mediation is a viable option, due to the fact that if the mediation process is an unfavorable

II. ANALYSIS OF THE IMPLEMENTATION OF ADR IN RESOLVING IRS-TAXPAYER DISPUTES

Recent history has certainly evidenced movement toward broader use of ADR in the resolution of tax disputes.[89] Both Congress and the IRS have recognized the potential value ADR is capable of providing for taxpayers and government alike.[90] Traditional negotiation, mediation, and arbitration have demonstrated how all parties can save time and money via participation in the Appeals process.[91] While the success of existing ADR mechanisms cannot be doubted, they may be open to even greater improvements in efficiency and quality. Particularly, the current Appeals structure, which relies predominantly on taxpayer-Appeals officer negotiation, presents problems as to very large or very small tax disputes.[92] Ultimately, the IRS and taxpayers would be well served were Appeals to shift its focus from a negotiation-based system to one that relies predominantly upon mediation.[93] With that in mind, this section will take a closer look at the strengths and weaknesses of each form of ADR currently used throughout the tax dispute resolution process.

A. *The Appeals Office—A Good Foundation*

The longevity of, and the Service's commitment to, the Appeals process rests largely on the fact that it has successfully produced resolution in most cases.[94] Appeals allows taxpayers to pursue settlement in a personal conference with the IRS and represents an advantageous alternative to litigation in many cases.[95] However, in spite of its impressive eighty-five to

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experience the taxpayer may still have his day in court. *Id.*; *see also* Robert A. Zarzar & James A. Dougherty, *AICPA Officials Testify on IRS Performance*, TAX NOTES TODAY (Jan. 28, 2003), LEXIS 2003 TNT 18-25 (noting that a strength of mediation is the fact that the mediator merely acts as a "facilitator for communication," having no authority to bind the parties).

[88] *See infra* discussion Part III.C.

[89] *See supra* Part II.

[90] *See generally* Scherer, *supra* note 2, at 215 (noting that the enactment of the Administrative Dispute Resolution Act was a response to dissatisfaction with the high costs of litigation).

[91] *See id.* (noting how Appeals settlement and other ADR procedures have the "primary intent of producing more efficient resolutions").

[92] *See infra* Part III.A.

[93] *See infra* Part IV.

[94] *See* Scherer, *supra* note 2, at 215.

[95] *See id.*

ninety percent settlement rate,[96] Appeals is not the best alternative when two distinct groups of taxpayers are involved: first, those with relatively few resources pursuing relatively small claims, and second, those with a great deal of resources pursuing relatively large claims.

Appeals does not necessarily provide complete fairness for taxpayers defending small claims. As a matter of economics, a small claim will not justify hiring professional counsel.[97] If the amount in controversy is not above a certain level, a taxpayer will probably choose not to pay for representation. Taxpayers may be disadvantaged, however, if they elect not to acquire professional representation.[98] According to the IRS, "[t]here is no need for [the taxpayer] to have representation at an Appeals conference."[99] However, those taxpayers that forego representation will sit across the table from Appeals officers, who—no matter how impartial and judicious—

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[96] *See supra* note 36. In 2000, Appeals had an inventory of about 58,000 cases. *Id.*

[97] In fact, "[l]egal representation is not available to most Americans who have legal problems." Robert R. Kuehn, *Denying Access to Legal Representation: The Attack on the Tulane Environmental Law Clinic*, 4 WASH. U. J.L. & POL'Y 33, 35 (2000). The economic reality facing potential litigants with relatively small claims is illustrated in shareholder class actions. John C. Coffee, Jr., *Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions*, 86 COLUM L. REV. 669, 678 (1986) (discussing the fact that individual clients have only a nominal stake in shareholder derivative actions). In those cases, an individual claim for a few hundred, or even a few thousand, dollars will not justify the expense that is incurred in hiring legal representation and pursuing litigation. *Id.* Taxpayers with relatively small amounts of money in dispute with the IRS are comparable to class action litigants, in that the individual claim is not large enough to warrant hiring legal representation.

Furthermore, the IRS will not necessarily make a similar economic calculation regarding small claims. That is, the IRS may vigorously pursue a claim merely for its potential precedential value. *See* Rev. Proc. 2002-44, 2002-26 I.R.B. § 3.07; Marcus & Senger, *supra* note 37, at 712 (noting that "[i]n tax litigation, a private party may be willing to compromise a monetary claim, whereas the government may be reluctant to do so—even on a reasonable basis from a risk-assessment standpoint—because of the need to establish a precedent for other cases.").

[98] *See* PUBLICATION 5, *supra* note 1. According to the IRS, a taxpayer may represent himself at an appeals conference or "may have an attorney, certified public accountant, or an individual enrolled to practice before the IRS represent" him. *Id.* Although a taxpayer can be represented by a certified public accountant [CPA] in Appeals, a CPA cannot represent a taxpayer in Tax Court unless he passes an examination. *See* Matthew A. Melone, *Income Tax Practice and Certified Public Accountants: The Case for a Status Based Exemption From State Unauthorized Practice of Law Rules*, 11 AKRON TAX J. 47, 54 n.31 (1995). Many of the inequities that arise from a taxpayer's lack of representation are mitigated when the taxpayer and IRS engage in mediation rather than negotiation. *See infra* Part III.B.

[99] PUBLICATION 5, *supra* note 1.

possess a degree of expertise as IRS employees.[100] This discrepancy may place taxpayers at a distinct disadvantage in some cases. Indeed, tax law

> will at times involve difficult questions of interpretation of statute or court decision, and the validity of regulations or statute; they will also involve doubtful questions of nontax law on which tax issues may depend . . . . Such questions, in general, are the kind for which lawyers are equipped by training and practice.[101]

Based on this disparity in expertise between an average taxpayer and an IRS Appeals officer, the current structure of Appeals presents the possibility that small tax disputes will be resolved inequitably, casting significant doubt on the ultimate efficacy of Appeals's seemingly impressive settlement rate.

An additional deficiency for small claimants in the Appeals system lies in the fact that the fear of "the burdens of litigation, primarily time and expense, often overwhelm the taxpayer,"[102] and may lead to a possibly inequitable settlement. Especially for relatively small claims, it may make little economic sense for a taxpayer to invest much time and money in a vigorous attempt to win a dispute,[103] causing the taxpayer to cut his losses and accept the existing IRS offer. Yet, even in the case of relatively small claims, this mentality may deprive taxpayers of plenary justice—a result that runs in the face of the Service's mission.[104] Ultimately, a taxpayer with limited financial resources may not be able to fully realize the strength of his claim, and that fact may lead to hastened and unfair settlement. By

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[100] *See* Korteling, *supra* note 6, at 673 & 680. "While the procedure [in Appeals] is not as formal as that in a court, the taxpayers facing technical or complex issues are at a significant disadvantage in preparing and presenting evidence to support their claim." *Id.* at 680.

[101] Melone, *supra* note 98, at 67 (quoting Gardner v. Conway , 48 N.W.2d 788, 797 (Minn. 1951)). Furthermore, tax law tends to be a very specialized and complex area of law. *See id.* at 82, 102.

[102] Lee G. Knight & Ray A. Knight, *Dispute Resolution with the IRS and Taxpayer Bill of Rights 2*, 13 AKRON TAX J. 27, 68 (1997). The cost of a vigorous defense of a tax dispute may lead to settlement, even though research of the issue would have revealed a high probability of success in court. *Id.*

[103] *See* Korteling, *supra* note 6, at 663 ("Expensive legal representation is not an economically feasible option for many taxpayers, including not only indigent taxpayers, but also large corporate taxpayers, except when the financial stake is significantly high.").

[104] "The IRS Mission: Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all." Internal Revenue Manual § 1.1.1.1, *available at* http://www.irs.gov/irs/article/0,,id=98141,00.html (last visited Sept. 24, 2003).

restructuring Appeals so that almost every case immediately enters mediation, these problems could be mitigated. Specifically, in mediation an unrepresented taxpayer will not be disadvantaged by his lack of expertise because a neutral third party is involved who will fairly assess the merits of each side's claim.[105]

The current Appeals system is equally deficient as to disputes over large monetary sums. The problem here is that the method employed by Appeals—negotiation—is not optimally suited for the most efficient resolution of large tax disputes.[106] The opportunity for face-to-face discussions will suffice to produce agreement in some cases,[107] but many cases are destined for litigation because the amount in controversy is so high that zealous representation is warranted.[108] Where the respective proposals of the taxpayer and the IRS are separated by hundreds of thousands of dollars, each side is much more likely to remain steadfast, justifying mounting costs—and the prospective costs of litigation—with the thought of how much will be won in the end.[109] The current structure of Appeals relies on negotiation to bring the taxpayer and IRS Appeals officer to an agreement. In fact, every case that enters Appeals must go through the negotiation process.[110] The potential of the current system is ultimately limited in cases where parties are unwilling or unable to gain a realistic view of the merits of their claims. Negotiation facilitates stalemate in these situations. This means that certain

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[105] *See infra* Part IV.

[106] *See* Friedman, *supra* note 33, at 767 (noting that negotiation often fails to settle many tax disputes because the parties "are unable to place in proper perspective the potential weaknesses of their own position or the strengths of the other party's."); Rock, *supra* note 61, at 69 ("After lengthy and arduous negotiations . . . [n]either side would move beyond its position, and litigation seems inevitable.").

[107] *See* Scherer, *supra* note 2, at 215.

[108] *See supra* note 97 (discussing the economic decisionmaking behind shareholder class action lawsuits). The economic decisionmaking involved in shareholder class action lawsuits, *i.e.*, the aggregation of claims, also supports the proposition that claims involving a large sum of money warrant vigorous pursuit. *See* Coffee, *supra* note 97, at 678; *see also* Knight, *supra* note 102, at 68 (noting that a colorable claim may not be pursued because of overwhelming costs); Korteling, *supra* note 6, at 663 (explaining that the high costs of defending a claim are not justified, "*except when the financial stake is significantly high*") (emphasis added); Steven Shavell, *Alternative Dispute Resolution: An Economic Analysis*, 24 J. LEGAL STUD. 1 (1995) (discussing the economic reasons why a party may prefer litigation over ADR).

[109] *But see* Rock, *supra* note 61, at 69 (explaining how the use of mediation effected the resolution of a dispute where the positions of the IRS and taxpayer had been separated by hundreds of thousands of dollars).

[110] *See* Wei *supra* note 6, at 552 (explaining that mediation and arbitration are available only when negotiations have failed).

cases will never be resolved through the negation process. Mediation can help remedy this problem. Mediation is successful largely because it allows a neutral third party to take a fresh look at the case, evaluating the merits of each side's claim.[111]

By requiring each case to go through the negotiation process, Appeals may cause one of two problematic results for large taxpayers. First, after spending over a year[112] in the Appeals system, a taxpayer may become dissatisfied with the progress of the available administrative remedies and decide to forgo mediation. Alternatively, a taxpayer may spend a significant amount of time in negotiation, only to eventually settle through mediation.[113] In either scenario, time and money are wasted. Mediation is more optimally suited for the resolution of large tax disputes, and by directing most cases to mediation immediately (and not requiring traditional negotiation to run its course), both taxpayers and the IRS would stand to save resources.

Ultimately, the impressive settlement rate demonstrated by Appeals must be questioned in two respects. First, of those cases that are settled, are the outcomes fair from the perspective of most taxpayers? In light of the probable lack of representation of many taxpayers and of a general fear of the cost and uncertainty of litigation, that question should probably be answered in the negative. And second, could an even more impressive settlement rate result from a process that forces the parties to reevaluate their proposals? A consideration of basic economics in decisionmaking demonstrates that this question should be answered in the affirmative. Therefore, a reconsideration of the effectiveness of Appeals—and a move toward a mediation-based system—may help lead to an increase in both the quality and quantity of tax dispute settlements within the IRS.

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[111] *See* Katz-Pearlman & Adelson, *supra* note 52, at 2626; *see also* WARE *supra* note 13, at § 4.13 (discussing the role a mediator plays in ascertaining a region of mutually acceptable settlement). Additionally, while a case may remain in Appeals for more than a year, mediation "causes the parties to look ahead to and focus on the actual mediation session, and, in turn, the actual mediation session forces the parties to concentrate exclusively, in a compressed time frame and in a settlement-oriented environment, on resolving the dispute." Jones, *supra* note 47.

[112] *See* Jones, *supra* note 47 (noting that "[i]t is not unusual for a large case to languish at appeals for more than a year or two").

[113] *See* Rock, *supra* note 61, at 69. After spending months in the negotiation phase of Appeals, "the parties were at an impasse." *Id.* The parties submitted the case to mediation and a settlement was quickly brought about. *Id.*

B. *Mediation—Realizing a Problem-Solving Mentality*

The Service's use of mediation is a promising development that should result in an increase in the number of cases resolved before litigation, and an improvement in the fairness of final settlement agreements.[114] The promotion of mediation is a means by which the IRS can work toward greater efficiency and fairness, and it may be a significant tool that could persuade the taxpaying public to rethink its preconceptions about what the IRS is all about.[115] Mediation is optimally suited for the resolution of many tax disputes, particularly those involving very large and very small claims. Specifically, through mediation, small claims may find more equitable settlement, and large claims may be settled more frequently, because mediation forces parties to focus on the strengths and weaknesses of their case.[116] The words of a high-ranking IRS director convey the potential mediation possesses toward those ends:

> [M]ediation gives you a chance to take another shot, a chance possibly to recruit an ally who may agree with your position and tell the Appeals Officer, "I think the taxpayer has a good argument." At the same time if there is a hole in your argument, you may find out in advance of litigation, and it gives you a chance to step back and settle.[117]

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[114] *See* Wei, *supra* note 6, at 559 (noting that "mediation is a handy tool in resolving taxpayer disputes of almost any color").

[115] *See id.* at 549 ("The IRS hopes that the use of mediation will improve the taxpayer's view of the tax collection system, thereby making taxpayers more willing to participate in paying taxes.").

The IRS has traditionally been viewed disapprovingly by the general taxpaying public. *See* William G. Andreozzi, Comment, *Prohibiting the Deduction for Non-Corporate Tax Deficiency Interest: When Treasury Goes Too Far*, 34 J. MARSHALL L. REV. 557, 559 (2001) (describing "the American public's perception of the IRS as an agency that abuses its power."). A 1999 Gallup poll found that 70% of Americans think the IRS has too much power, and 69% think that its power is misused. *Id.* at 559 n.10; *see also* The Gallup Organization, *Public By 3 to 1 Margin Believes IRS Abuses Its Powers*, *at* http://www.gallup.com/poll/releases/pr971003.asp (last visited Sept. 24, 2003).

The development of mediation mechanisms by the IRS demonstrates the agency's awareness of its public image and its desire to reshape public perceptions. *See Resolving Actual and Potential Disputes*, *supra* note 42, at 263 (emphasizing an "overall strategy [that is] . . . less contentious, and less burdensome . . . ."). In fact, an IRS official strongly supports mediation at least in part because it may demonstrate a transformation from an agency in "the issue-raising business" to one in "the issue resolution business." *Id.*

[116] *See* Jones, *supra* note 47.

[117] *Resolution of Federal Income Tax Controversies*, *supra* note 5, at 276.

Along with the intrinsic benefits of its methodology (*i.e.*, informality, flexibility, and forcing parties to reexamine the strength of their claims), mediation offers tremendous economic benefits.[118] That is, the parties involved—both the taxpayer and the IRS—stand to save time and money when mediation is successful and litigation is avoided.[119]

Confidentiality and impartiality are two characteristics that are essential to successful mediation.[120] The confidentiality of mediation communications may vary according to whether the mediation is in Appeals or in a federal court. In Appeals, the mediation process is confidential.[121] Accordingly, the communication that takes place in the mediation session should not be subject to discovery in later judicial proceedings. The confidentiality of mediation proceedings in federal court, however, is less certain. Although particular rules of evidence may protect mediation communications,[122] there is no federal evidentiary rule that explicitly protects confidential mediation communications. A rule of evidence explicitly protecting mediation communications from discovery and admissibility in a subsequent judicial proceeding should be promulgated, so as to encourage open communication in the mediation process.

The Service's mediation programs, however promising, contain room for improvement regarding mediator impartiality. Deficiencies in this area could

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[118] *See* Rock, *supra* note 61, at 72.

[119] *Id.* ("mediation offers substantial advantages—and few disadvantages—in cases where differences between the taxpayer and Appeals are unresolved."); *see also* Carlton M. Smith, *Innovative Settlement Techniques Can Reduce Litigation Costs*, 78 J. TAX'N 76, 79–80 (1993).

The benefits of mediation could also be more fully realized with the promulgation of formal Tax Court rules, similar to those set forth in Rule 124 regarding arbitration. *See* Collins, *supra* note 48. Currently, Rule 124 merely mentions that mediation is available for use in Tax Court and is used at that level at the discretion of the judge. *Id.* If mediation were significantly addressed in Tax Court procedural rules, its availability would become more widely known and its use might be encouraged to a greater extent. *Id.*

[120] *See supra* text accompanying notes 53 & 54.

[121] *See* Rev. Proc. 2002-44, 2002-26 I.R.B. § 5.10. "[A]ll information concerning any dispute resolution communication is confidential and may not be disclosed by any party, participant, observer or mediator except as provided by statute, such as in § 6103 of the Internal Revenue Code and 5 U.S.C. § 574." *Id.*

[122] *See* Mostovoi, *supra* note 53, at 1876 n.42. Federal Rule of Evidence 408 prohibits disclosures of offers in compromise. Fed. R. Evid. 408. Rule 501 deals with evidentiary privileges. Fed. R. Evid. 501. That rule states that the law of evidentiary privileges "shall be governed by the principles of the common law." For an examination of the applicability of evidentiary privilege to mediators, see *In re* Anonymous, 283 F.3d 627, 639 (4th Cir. 2002); NLRB v. Macaluso, 618 F.2d 51 (9th Cir. 1980); Smith v. Smith, 154 F.R.D. 661 (N.D. Tex. 1994). *See* Mostovoi, *supra* note 53, at 1876 n.42.

potentially lead to serious inequities for taxpayers and compromise the ultimate effectiveness of mediation. One of the key characteristics of successful mediation is the impartiality and independence of the mediator.[123] In its pilot programs, the IRS had given taxpayers a choice in selecting a mediator.[124] The taxpayer could select an independent mediator or elect to use an Appeals officer who was trained as a mediator.[125] The IRS clearly favored the use of its own personnel, and reserved the right to not mediate if the taxpayer chose a non-IRS employee.[126] Proponents of the use of an in-house mediator argue that using a mediator familiar with tax issues is vital to the efficiency of the system.[127] Based on the success of similar programs in other government agencies, it is believed that bias in favor of the IRS position is not a significant problem.[128] In fact, the IRS is so confident that an in-house mediator will not compromise the program, that its newest initiative eliminates the taxpayer's choice altogether.[129] Under the new plan, the mediator will be an employee of the IRS.[130] The mediator may even be a member of the same office in which the taxpayer's case is assigned.[131]

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[123] *See* WARE, *supra* note 13, § 4.15; *see also supra* text accompanying notes 53 & 54. Mediator selection is critical to the success of the mediation process and must be "scrutinized carefully" because the mediator will influence the entire process. *See* Wei, *supra* note 6, at 558.

[124] *See* Wei, *supra* note 6, at 558.

[125] *See* Jones, *supra* note 47. If the taxpayer selected an independent mediator, the mediator's fees were split between the IRS and the taxpayer. However, if the taxpayer chose an Appeals officer as mediator, the taxpayer was not liable for any of the cost of employing the mediator's services. *Id.*

[126] *See id.* (noting that almost all mediation sessions involved an Appeals mediator and that use of an Appeals mediator was implicitly required).

[127] *See* Wei, *supra* note 6, at 567 (noting that "[t]he use of non-IRS mediators may slow down the mediation process because the mediators are not familiar with tax issues and the tax law").

[128] *See id.* Special mediator training is believed to compensate for possible problems in impartiality. *See id.* at 563 n.90, 567 n.119.

[129] *See* Jones, *supra* note 47; *see also* Rev. Proc. 2002-44, 2002-26 I.R.B. 10 § 5.

[130] Rev. Proc. 2002-44, 2002-26 I.R.B. 10 § 5.07. Every mediation session in Appeals must involve an Appeals mediator, but the taxpayer may be able to bring in a non-IRS co-mediator. *Id.* § 5.08. The basic qualifications of a non-IRS co-mediator include: "completion of mediation training, previous mediation experience, a substantive knowledge of tax law, or knowledge of industry practices." *Id.*

[131] *Id.* ("The taxpayer and the Appeals Team Manager will select an Appeals mediator from a list of eligible individuals who, generally will be from the same Appeals office or geographic area, but not the same group, where the case is assigned.")

There are apparent advantages to using in-house personnel for mediation.[132] For example, an Appeals mediator presumably possesses expertise regarding tax issues and will be able to fully understand a taxpayer's claim.[133] This may not be the case with a truly independent mediator who may lack tax expertise. Second, an Appeals mediator will be able to offer considerably more practical experience in tax dispute settlements than most private mediators.[134] Finally, being a part of the IRS, an Appeals mediator is likely to possess an "institutional incentive" to have the case result in settlement.[135] However, even if Appeals mediators can in fact be neutral, and even if they possess advantages over non-expertised mediators, the perception of a lack of impartiality among taxpayers may limit the number of taxpayers who are willing to pursue mediation, thereby limiting the overall effectiveness of the program.[136] Therefore, the IRS should modify its mediator selection procedures to at least give taxpayers the option of having a non-IRS mediator.

C. *Arbitration—Still A Good Alternative to Litigation*

Like the other forms of ADR utilized in resolving tax disputes, arbitration offers significant advantages over litigation. First, arbitration creates a much more favorable atmosphere for taxpayers, especially those

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[132] *See* Jones, *supra* note 47 (noting that an "appeals mediator comes to the table with at least several distinct advantages over a private sector mediator"); Wei, *supra* note 6, at 567 ("The use of non-IRS mediators may slow down the mediation process because the mediators are not familiar with tax issues and the tax law").

[133] *See* Jones, *supra* note 47. Furthermore, "the appeals mediator knows what motivates another appeals officer, how she or he thinks, how that person's supervisor factors into the settlement process, and how the unwritten rules at appeals influence the process." *Id.*

[134] *Id.* (noting that "[a] taxpayer would be hard-pressed to find a private-sector mediator who has handled as many federal tax settlements as an experienced appeals mediator").

[135] *Id.* The fact that an Appeals mediator is "charged by appeals with mediating and settling cases" shows that the IRS, at least in some respects, associates the occupational success of its Appeals officers with their ability to settle cases. *Id.* Support of this concept is seen in remarks by Large and Mid-Size Business Division director Larry Langdon, "we want to institutionalize the concept that we're in the issue resolution business rather than the issue-raising business. It's important both internally and externally that we change our cultures to reflect that." *Resolving Actual and Potential Disputes*, *supra* note 42, at 263; *see also* Marcus & Senger, *supra* note 37, at 722 (discussing the importance of institutionalizing dispute resolution mentalities in other government agencies).

[136] *But see* Jones, *supra* note 47 (arguing that having an Appeals mediator from a different part of the country would suffice to assure taxpayers of impartiality).

with small claims, that do not have legal representation.[137] Tax Court presents two significant factors that disadvantage non-expertised taxpayers. The most obvious is that the taxpayer presents his case against a trained lawyer that is knowledgeable of tax law.[138] The taxpayer is further handicapped by the court's strict rules of evidence.[139] The use of arbitration can mitigate these inequities.[140] The taxpayer's lack of legal knowledge is aided by the fact that an increased level of informal interaction is permitted with the arbitration panel as compared to what the degree of interaction the taxpayer would experience with a Tax Court judge.[141] Additionally, arbitration is characterized by less formal rules of evidence, allowing the taxpayer to make a more effective statement of his case.[142] So, especially for those taxpayers who have chosen not to have—or who simply cannot afford—legal representation, arbitration offers meaningful advantages over litigation. Arbitration can also lessen the caseload of the Tax Courts.[143] Cases laden with factual issues eat up valuable court time, and arbitration can be used to resolve many of those disputes without litigation.[144]

Arbitration, however, offers few advantages over mediation. The advantages arbitration presents to pro se taxpayers are only amplified in mediation.[145] Compared to arbitration, mediation presents even fewer

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[137] *See* Korteling, *supra* note 6, at 681.

[138] *Id.*

[139] *Id.*

[140] Arbitration mitigates the burdens associated with the adversarial process. *Id.* In tax litigation, pro se taxpayers are typically disadvantaged by their lack of knowledge of often complex tax law. *Id.* That lack of knowledge inevitably affects the taxpayer's ability to fully argue the merits of his claim. Arbitration eases this burden because it "allow[s] dialogue between the taxpayer and the arbitration panel that is more open than that between the taxpayer and a judge." *Id.*

Arbitration is particularly beneficial for pro se taxpayers because the applicable rules of evidence are much less stringent than those in litigation. *Id.* Therefore, "[a]lthough a taxpayer proceeding pro se might not be able to present his case as effectively as experienced counsel might, taxpayers who normally would not obtain counsel benefit by presenting evidence more effectively." *Id.*

[141] *Id.*

[142] *Id.*

[143] *Id.* at 682.

[144] *Id.* at 682–83.

[145] *See* Scherer, *supra* note 2, at 218. The primary reason a taxpayer would not seek representation is cost. Indeed, the primary reason why mediation is a favored form of ADR is that its flexibility and efficiency make it "time- and cost-effective." *Id.* at 218 n.31.

obstacles for an untrained, non-expertised taxpayer.[146] For this reason, the IRS should focus more on the development of its mediation programs than arbitration. Additionally, the Tax Court should consider making mediation more of a priority for docketed cases.

IV. BRINGING ABOUT EVEN GREATER EFFICIENCY IN TAX DISPUTE RESOLUTION

The IRS Appeals Office truly does operate as an alternative dispute resolution forum.[147] That is, through the Appeals process, eighty-five to ninety percent of all tax disputes are resolved outside of a courtroom.[148] However, the current Appeals system is not optimally suited to the most efficient and fair resolution of tax disputes.[149] Taxpayer-Appeals officer negotiations may lead to inequitable settlements in small tax disputes, and many large tax disputes may go unresolved after the Appeals process has run its course. In light of the fact that the current Appeals structure displays areas that warrant improvement, the IRS should pursue a major restructuring of its dispute resolution process. That restructuring should entail a commitment to mediation, rather than negotiation.[150]

The IRS should restructure its Appeals Office so that mediation is the default method of dispute resolution. Mediation should not just be pursued in the event that negotiation fails to bring about settlement;[151] instead,

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[146] *See* Collins, *supra* note 48. Mediation is particularly well-suited for unrepresented taxpayers because it "provid[es] an informal environment for the parties to discuss the specifics of their case with candor, as well as provid[es] interpretation of the law applicable to the dispute." *Id.*

[147] *See* Scherer, *supra* note 2, at 215 (describing how the Appeals process operates essentially as negotiation between taxpayers and IRS Appeals officers).

[148] *See supra* note 5.

[149] *See supra* Part III.A; *see also* WARE, *supra* note 13, § 4.30.

[150] Additionally, given the fact that mediation is particularly well-suited for the resolution of tax disputes, the Tax Court should promulgate rules regarding mediation at that level. The benefits of ADR could also be more fully realized with the development of additional rules regarding mediation in Tax Court. While an additional round of mediation in Tax Court will likely be unproductive where a case has already gone through the process in Appeals, mediation should be encouraged in Tax Court when the taxpayer chooses to forgo the Appeals process. Promulgation of formal procedural rules for mediation in Tax Court would make mediation a more viable option at that stage.

[151] *See* Rev. Proc. 2002-44, 2002-26 I.R.B. 10 § 4.01 (mediation "may be used only after Appeals settlement discussions are unsuccessful"); *see also* Scherer, *supra* note 2, at 217. Because most cases are settled in Appeals, the IRS has designed other ADR procedures "so as to insure that the new procedures do not undermine the Appeals process." *Id.*

taxpayers and the Appeals officers should sit down with a third party neutral from the outset so that a greater number of and higher quality resolutions can be effected. The IRS does make mediation available before a case even reaches Appeals through its fast track mediation program, but that alternative is inadequate because of the restraints placed on IRS agents at that level.[152]

The current Appeals system presents two major problems. First, small taxpayer claimants are susceptible to unfair treatment.[153] Second, large claims are less likely to be resolved through simple taxpayer-Appeals officer negotiations.[154] The introduction of a third party neutral into the process ameliorates these problems.[155] Specifically, a neutral third party will likely act as a prophylactic against the potential inequitable results that may arise when expertised and non-expertised persons face off. Moreover, a neutral third party will act as a sounding board that can prompt parties to reexamine the strengths and weaknesses of their claims.[156]

Other interests may also be furthered with a full-scale implementation of mediation. The IRS and taxpayers could both benefit from a more widespread use of mediation.[157] The most obvious benefit to both parties is time and cost savings.[158] A secondary benefit for the IRS would be that as nearly every dispute goes through the mediation process, the institutional mentality within the Service—and perhaps even the external perception of the IRS by the taxpaying public—will develop an expectation that nearly all disputes can be fairly resolved without litigation.[159] A resolution-focused

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[152] *See* James A. Dougherty & Tracey A. Fielman, Large and Mid-Size Division Fast Track Dispute Resolution Pilot Program, The Tax Executive, Jan.–Feb. 2002, at 41, *available at* http://www.irs.gov/pub/irs-utl/fasttrack.pdf (last visited Sept. 25, 2003) (because IRS agents cannot consider the hazards of litigation in determining acceptable settlement figures, no substantive negotiations can take place); *see also* B. John Williams, Jr., *IRS Chief Counsel Offers Tax Shelter Resolution Strategies*, Tax Notes Today (Feb. 28, 2003) *available at* LEXIS 2003 TNT 40-20 ("The hazards of litigation are the primary factor in determining the terms of any settlement initiative."); Pamela J. Gardiner, *Taxpayers Should Be Informed of the Benefits of the Fast Track Mediation Program*, Report of the Treasury Inspector General for Tax Administration (March 2002), *available at* http://www.ustreas.gov/tigta/2002reports/200210070fr.pdf (last visited Sept. 25, 2003).

[153] *See supra* Part III.A.

[154] *See supra* Part III.A.

[155] *See supra* Part III.B.

[156] *See* Rock, *supra* note 61, at 72.

[157] *See* Wei, *supra* note 6, at 569. "Mediation can result in significant cost and time savings to the IRS. Such benefits would please the taxpayers and IRS alike." *Id.*

[158] *See* Rock, *supra* note 61, at 72.

[159] *See Resolving Actual and Potential Disputes*, *supra* note 42, at 263; *see also supra* text accompanying note 152.

atmosphere will, in turn, perpetuate cost savings for both parties as more cases find resolution more quickly. As mediation is used more in the ordinary course of events within the IRS, the quantity and quality of successfully mediated settlements are likely to increase. The IRS and taxpayers will avoid the cost of litigation, and taxpayers will be more likely to benefit from the product of the mediation process.

The implementation of a mediation-focused Appeals Office would require two initial determinations. First, Appeals would need to determine which cases would qualify. Second, Appeals would need to determine for which cases, if any, mediation would be mandatory. The first issue may easily be answered: all cases within the jurisdiction of Appeals qualify. Any tax dispute that has reached Appeals can be submitted to mediation; negotiation sessions do not have to prove ineffective before mediation is available. This then leads to the second determination. Initially, it is important to point out that not every tax dispute finds its way to Appeals. A taxpayer has the right to forego the Appeals system altogether and immediately sue the IRS.[160] But of those cases that are pursued within Appeals, most should be handled through mediation. As a practical matter, in some cases, the respective positions of the taxpayer and the Service are close enough so that the dispute can be resolved with minimal time and effort by either party.[161] With that in mind, cases should not be immediately directed to mediation. Instead, only if the dispute is not resolved through an initial phone conversation or meeting, should mediation be mandatory. Mediation, then, should be the second step in the Appeals process.

Additionally, important changes should be made in the Service's mediation procedure. Using Appeals officers as mediators presents serious inequities for taxpayers and may contribute to a perception among taxpayers that they cannot get a fair deal.[162] In order to eliminate a lack of real or potential impartiality, taxpayers should have three options regarding mediator selection. The first two options involve just one mediator, while the third would involve two persons acting as co-mediators. First, a taxpayer should have the right to request that a non-IRS mediator be the sole mediator. Second, a taxpayer could agree to use an IRS employee mediator. This option should be paralleled by the creation of a mediator division within the IRS so that Appeals officers do not perform the role of IRS advocate one day and act as neutral mediators another. This mediator division would be wholly separate from Appeals, and its mediators would perform just one function—

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[160] If a taxpayer foregoes his Appeals rights and immediately sues the IRS, mediation may still be available. *See supra* note 150.

[161] *See* PUBLICATION 5, *supra* note 1.

[162] *See supra* Part III.B.

that of mediator. A third option for taxpayers would be to use both an IRS and non-IRS mediator.[163]

With a transformation of Appeals from a system that relies predominately on taxpayer-Appeals officer negotiations to one that focuses on mediation, all parties involved in tax disputes will benefit. Mediation will ensure that small claims are settled fairly for taxpayers and will lead to a greater number of settlements in large disputes. Additionally, the IRS will benefit from an increase in time and cost savings. The development of ADR demonstrates recent efforts to improve the service, efficiency, and perception of the IRS. Unfortunately, decades of apparent success with the Appeals Office has lulled the IRS into believing that new forms of ADR should only supplement the traditional use of negotiation techniques. However, to achieve optimum service, efficiency, and goodwill, the IRS should pursue mediation more fully.

V. CONCLUSION

The IRS, despite its notorious reputation, has been in the alternative dispute resolution business for over seventy-five years.[164] Perhaps only recently, however, has the Service made customer service a priority. In pursuit of this goal, and in an effort to comply with congressional mandate, ADR mechanisms have been developed to supplement the success of the Appeals Division.[165] In addition, arbitration and mediation remain viable options even after a case leaves Appeals without a settlement.[166]

Assessment of the success and future of the new ADR initiatives depends on how well they address the deficiencies that have existed in the Appeals Office. Careful analysis demonstrates that mediation has the potential to considerably mitigate unfairness that exists in the Appeals process for small taxpayer claimants. The nature of the mediation process allows taxpayers to fairly engage with the IRS even when they do not employ legal representation.[167] Moreover, mediation will force the IRS and taxpayers to carefully scrutinize the merits of their claims, leading to the settlement of an even greater number of large tax disputes. A system that appears fair will promote even greater confidence in resolution outside of court and ultimately

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[163] *See* Rev. Proc. 2002-44, 2002-26 I.R.B. 12 § 5.06 (the IRS currently permits taxpayers to elect to use a non-IRS co-mediator, at the taxpayer's expense).

[164] *See* Louthan & Wrappe, *supra* note 9, at 1473.

[165] *See* Scherer, *supra* note 2, at 215.

[166] *See* T.C.R. 124.

[167] *See supra* Part III.B.

provide tremendous incentive for taxpayers to avoid the expense of litigation altogether.

While significant changes can still be made, particularly with the use of truly impartial mediators, the promise that mediation provides should persuade the IRS to undergo a major restructuring of its Appeals Office, making mediation the core of its administrative dispute resolution process.